IN THE

Supreme Court of the United States

October Term, 1960.

No.

GEORGE S. MUNSON and KATHARINE S. MUNSON,
Petitioners,

EDGAR A. McGINNES, Individually and as United States District Director of Internal Revenue for the Internal Revenue District of Philadelphia, Pennsylvania,
Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

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Counsel for Petitioners

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GEORGE S. MUNSON AND KATHARINE S. MUNSON,
Petitioners,

v.

EDGAR A. McGINNES, INDIVIDUALLY AND AS UNITED STATES DISTRICT DIRECTOR OF INTERNAL REVENUE FOR THE INTERNAL REVENUE DISTRICT OF PHILADELPHIA, PENNSYLVANIA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT.

Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Third Circuit, entered in the above-entitled case on June 8, 1960.

CITATIONS TO OPINIONS BELOW.

The opinion of the District Court is reported in 178 F. Supp. 380 and is printed in the Appendix hereto at p. 1a. The opinion of the Court of Appeals is reported at — F. 2d — and is printed in the Appendix hereto at p. 6a.

JURISDICTION.

The judgment of the Court of Appeals was entered on June 8, 1960. Rehearing was denied on July 25, 1960. The jurisdiction of this Court is invoked under 28 U. S. C. Section 1254(1).

QUESTION PRESENTED.

Where a taxpayer recovers taxable capital gains in 1954 with respect to sales of stock consummated in 1936, are the legal expenses incurred and paid in effecting such recovery deductible from taxpayer's gross income under Section 212 of the Internal Revenue Code of 1954 as ordinary and necessary expenses incurred in the collection of income?

STATUTES AND REGULATIONS.

The statutory provision involved in Section 212 of the Internal Revenue Code of 1954, 26 U. S. C. Sec. 212, which provides as follows:

> "SEC. 212. EXPENSES FOR PRODUCTION OF INCOME.
>
> In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—
>
> (1) for the production or collection of income;
>
> (2) for the management, conservation, or maintenance of property held for the production of income; or
>
> (3) in connection with the determination, collection, or refund of any tax."

The regulations involved are the following portions of the Income Tax Regulations (26 C. F. R. § 1.212-1):

"SEC. 1.212-1; NONTRADE OR NONBUSINESS EXPENSES.

(a) An expense may be deducted under section 212 only if—

(1) It has been paid or incurred by the taxpayer during the taxable year (i) for the production or collection of income, which, if and when realized, will be required to be included in income for Federal income tax purposes, or (ii) for the management, conservation, or maintenance of property held for the production of such income, or (iii) in connection with the determination, collection, or refund of any tax; and

(2) It is an ordinary and necessary expense for any of the purposes stated in subparagraph (1) of this paragraph.

(b) The term 'income' for the purpose of section 212 includes not merely income of the taxable year but also income which the taxpayer has realized in a prior taxable year or may realize in subsequent taxable years; and is not confined to recurring income but applies as well to gains from the disposition of property. For example, if defaulted bonds, the interest from which if received would be includible in income, are purchased with the expectation of realizing capital gain on their resale, even though no current yield thereon is anticipated, ordinary and necessary expenses thereafter paid or incurred in connection with such bonds are deductible. Similarly, ordinary and necessary expenses paid or incurred in the management, conservation, or maintenance of a building devoted to rental purposes are deductible notwithstanding that there is actually no income therefrom in the taxable year, and regardless of the manner in which or the purpose for which the property in question was acquired. Expenses paid or incurred in managing, conserving, or maintaining property held for investment may be de-

ductible under section 212 even though the property is not currently productive and there is no likelihood that the property will be sold at a profit or will otherwise be productive of income and even though the property is held merely to minimize a loss with respect thereto.

* * *

(k) Expenses paid or incurred in defending or perfecting title to property, in recovering property (other than investment property and amounts of income which, if and when recovered, must be included in gross income), or in developing or improving property, constitute a part of the cost of the property and are not deductible expenses. Attorney's fees paid in a suit to quiet title to lands are not deductible; but if the suit is also to collect accrued rents thereon, that portion of such fees is deductible which is properly allocable to the services rendered in collecting such rents. Expenses paid or incurred in protecting or asserting one's rights to property of a decedent as heir or legatee, or as beneficiary under a testamentary trust, are not deductible."

STATEMENT.

This was a suit in the United States District Court for refund of 1954 Federal income tax, over which suit the District Court had jurisdiction under 28 U. S. C. Section 1340. The case was decided by the Court on a Motion to Dismiss filed by Defendant, and the facts hereafter stated are those alleged in the Complaint.

In the year 1936, Petitioner George S. Munson (hereinafter referred to as the "Petitioner", since Katharine S. Munson, his wife, is a party hereto only by reason of their joint income tax return), was the owner of 152½ shares of the preferred stock and 412½ shares of the common stock of Williamsport Wire Rope Company (hereinafter called "Williamsport"), which on September 16, 1932, had been

placed in receivership in the United States District Court for the Middle District of Pennsylvania under proceedings instituted by its creditors, the principal creditor being Bethlehem Steel Company (hereinafter called "Bethlehem").[1]

Bethlehem, which in the year 1936 owned all but a negligible part of the outstanding bonds (then in default) of Williamsport, had caused the trustee under the mortgage securing such bonds to file a petition in the receivership proceedings on September 14, 1936, asking leave of the court to foreclose the mortgage.

Thereafter, on November 6, 1936, Petitioner sold all of his shares of common stock of Williamsport to Bethlehem at $10.00 per share, and on December 12, 1936, Petitioner sold all his shares of preferred stock of Williamsport to Bethlehem at $40.00 per share. Such sales resulted in losses in 1936, since not all of the tax basis of the stock was recovered.

Through subsequent foreclosure proceedings, all of the assets of Williamsport were sold and delivered at public sale on May 27, 1937, to Bethlehem, with the result that Williamsport was thereby completely liquidated.

On February 16, 1946, a petition was filed, in the court in which the receivership had taken place, by stockholders, former stockholders and former bondholders of Williamsport alleging that the sale of assets to Bethlehem was procured by a fraudulent conspiracy and asking that the receivership action be reopened, and the said sale be set aside and all of the assets be declared to be the property of all shareholders, former shareholders and former bondholders of Williamsport joining in the action. Other stockholders and former stockholders and bondholders subsequently

1. The Estate of C. LaRue Munson, of which Petitioner in 1954 was an income beneficiary, also owned stock of Williamsport, and the transactions described herein are also applicable to it and are a part of Petitioner's claim. However, in the interest of simplicity this statement will discuss only the individually owned stock, since that is sufficient at this point to show the issue involved.

joined in the proceedings. Among the former stockholders represented in the action was the present Petitioner, George S. Munson.

After considerable testimony was heard by a Special Master, and upon his findings and recommendations, the Court held (in a decision reported at 107 F. Supp. 759 (1952)) that the sale of assets to Bethlehem had resulted from a fraudulent conspiracy and the sales of stock to Bethlehem after July, 1936, had been induced by fraud. A decree was entered declaring Bethlehem Steel Company constructive trustee of such assets and of the stock so purchased after July, 1936, for the benefit of the rightful owners, namely, former Williamsport shareholders.

A motion for a new trial was filed by Bethlehem, and while that motion was pending the parties agreed to a settlement whereby Bethlehem was to pay into court the sum of $6,000,000 and deposit with the court stock certificates of Williamsport for all stock Bethlehem purchased after July, 1936, for the purpose of identifying the former owners thereof. The settlement was approved by the court, and the Special Master was directed to make recommendations as to the distribution of the $6,000,000 paid by Bethlehem. (As shown by Opinion and Decree reported at 107 F. Supp. 762, approving the settlement, the court vacated its previous order and specifically found, on a re-review of the evidence, that Bethlehem had not participated in any fraud.)

The Special Master thereafter filed a report dated December 21, 1953, under which he recommended a partial distribution, which was made in 1954, including the amount of $25,187.65 to Petitioner by reason of his former ownership of the said shares of preferred stock and of $196,094.54 to him by reason of his former ownership of the said shares of common stock.

By reason of Petitioner's recovery, he was obligated to pay, and in 1954 did pay, from his own funds to Charles Bidelspacher, Jr., an attorney of Williamsport, Pennsylvania, who filed the Petition of February 16, 1946 on behalf

of the stockholders and prosecuted it to its conclusion, a counsel fee of $110,641.10.

In his joint income tax return of 1954, Petitioner, being on the cash basis, included the amounts recovered (less the remaining portion of his stock basis from which he received no tax benefit in 1936) as a long-term capital gain subject to the alternative tax on capital gains and in computing ordinary net income deducted from gross income the expenditure by him of the counsel fee as an ordinary and necessary expense paid or incurred during the taxable year for the collection of the capital gain.

On examination of Petitioner's 1954 return by the Internal Revenue Service, the paid counsel fee of $110,641.10 was disallowed as an ordinary expense deduction from gross income but was treated as an offset against the aforesaid capital gain.

Petitioner, having paid increased income tax of $39,641.63, together with interest thereon of $4,721.32, filed a timely claim for refund, and, thereafter, a timely suit for refund in the District Court. The Defendant filed a Motion to Dismiss for alleged failure to state a claim upon which relief can be granted, which motion was granted on October 1, 1959 and the action dismissed. The District Court based its decision on the conclusion that Plaintiff in 1954 recovered from Bethlehem the stock which he had sold to Bethlehem in 1936 and then immediately resold such stock to Bethlehem, with the counsel fee constituting a nondeductible expense of such recovery and resale. The Court of Appeals rejected the theory that Petitioner recovered and then resold his stock, but nevertheless affirmed the decision of the District Court on the new theory (not even argued by Defendant) that the 1954 expenditure for counsel fees was a nondeductible expense of the original sale of the stock, which the Court agreed was consummated in 1936.

REASONS FOR GRANTING THE WRIT.

1. Conflict With Other Circuit Court Decisions.

Section 212 of the Internal Revenue Code allows as a deduction from ordinary income expenses paid "for the production or collection of income." The word "income", as used in Section 212, includes capital gains. See Regulations, p. 3, *supra*. This is in accord with Section 61 of the Code which provides that "gross income means all income from whatever source derived, including . . . Gains derived from dealings in property. . . ." As held by this Court in *Helvering v. Bliss*, 293 U. S. 144 (1934), the fact that capital gains may be segregated and taxed at a special rate[2] does not make it any the less a part of the taxpayer's gross income.

Concededly, Petitioner recovered in 1954 an additional capital gain with respect to a sale of stock which he consummated in 1936, and the legal expenses involved were incurred in effecting such recovery. Until the decision of the court below, all Circuit Court decisions which have considered the question held that such legal expenses were deductible under Section 212. But the court below held that the 1954 expenses must be related back to the previously consummated 1936 sale and treated as expenses of such sale. The effect of so holding is to render Section 212 inapplicable to expenses relating to the recovery of capital gains income.

In the Court of Appeals, the Defendant contended that the Court should refuse to follow three other Circuit Court decisions relied upon by Petitioner. Defendant argued that *Coke v. Commissioner*, 17 T. C. 403, aff'd per curiam 201 F. 2d 742 (CA 5th), and officially acquiesced in by the Commissioner (1953-2 C. B. 3), "would seem to be based on an

2. Section 1201 of the Code fixes the maximum rate on long term capital gains at 25% for the year here involved.

erroneous interpretation of the Regulations and an unwarranted extension of the provisions contrary to the great weight of authority." As to *Naylor v. Commissioner*, 203 F. 2d 346 (CA 5th), Defendant stated that it "also seems to be contrary to weight of authority." Finally, as to *Heller v. Commissioner*, 2 T. C. 371 aff'd 147 F. 2d 376 (CA 9th), he said: "It is difficult to say the case is in harmony with later decisions."

Defendant made no effort to distinguish the *Coke* and *Heller* cases, made only a faint effort to distinguish the *Naylor* case, and impugned his own references to the alleged "weight of authority" by stating, earlier in his brief (p. 21), that "We find no case involving precisely the factual situation presented on this appeal . . ."

In its Opinion, the Court of Appeals also made no effort to distinguish the *Coke* case, but expressly refused to follow it, made no mention of the *Heller* case, and distinguished the *Naylor* case on grounds not even contended for by Defendant. In addition, the Opinion failed to consider or mention another case, directly conflicting with this case in its holding, namely, *Ruoff v. Commissioner*, decided by the same Circuit on April 6, 1960, after the argument in the present case.

The decision of the Court of Appeals in the instant case conflicts with the foregoing decisions in the following respects:

(a) *Coke v. Commissioner*, 17 T. C. 403, *aff'd*, 201 F. 2d 742 (5th Cir. 1953), *acq.* 1953-2 C. B. 3.

In the *Coke* case, the taxpayer entered into a property settlement agreement which was followed by a divorce. Subsequently, she brought suit to set aside the settlement on the grounds that community property consisting of 24,570 shares of stock and 8,000 options of Southern Aircraft Corporation had been improperly treated as the husband's separate property in making the settlement. A new

settlement was reached under which the stock and options were conceded to be community property and were placed in escrow with a bank, sold, and the net proceeds distributed equally between the parties. The taxpayer received in the distribution a total of $246,560 of which $61,425 represented recovery of her original cost of the stock and options. She reported the difference as capital gain. Petitioner expended in the litigation $100,637.27, which she deducted as ordinary and necessary expenses paid for the production or collection of income under Section 23(a)(2), the predecessor in the 1939 Code of Section 212. The court held that to the extent that the expenses were incurred in actually recovering title to the property (i.e., to the extent attributable to recovery of the original cost) they were capital expenditures to be added to the cost of the recovered property, but the remainder (i.e., to the extent attributable to recovery of the capital gain) was held deductible from ordinary income under Section 23(a)(2). The court said (p. 407):

> "The remainder of the legal expenses in question, however, we think unquestionably are deductible from gross income under section 23(a)(2), as petitioner contends. That section provides that there shall be allowed as deductions as nontrade or nonbusiness expenses 'all the ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income.' Respondent determined that petitioner realized long-term capital gain from the sale of the above-mentioned stock and options of Southern Aircraft Corporation. Respondent's own regulations provide that 'the term "income" for the purpose of section 23(a)(2) * * * is not confined to recurring income but applies as well to gains from the disposition of property', Regulations 111, section 29.23(a)-15(a), such as were realized here. Similarly, Regulations 111, section 29.23(a)-15(b) provides that 'expenditures incurred in defending or perfecting title to property, in recovering

> property (other than investment property and amounts of income which, if and when recovered, must be included in income), * * * constitute a part of the cost of the property and are not deductible expenses'. The plain inference of this language is that expenditures incurred in recovering 'amounts of income which, if and when recovered, must be included in income', as here, are deductible expenses."

The Court of Appeals in the present case recognized that the *Coke* case would require a decision for Petitioner. However, the Court expressly refused to follow the *Coke* case saying (13a):

> "Finally, we have not overlooked taxpayer's urging that *Coke v. Commissioner*, 1951, 17 T. C. 403, *aff'd. per curiam*, 5th Cir. 1953, 201 F. 2d 742, supports his claimed deduction. That was a case in which property belonging to a wife had been wrongfully withheld from her in a settlement made on divorce. Question arose as to the tax treatment of expenses she incurred in recovering from her divorced husband an amount which was viewed as both a recapture of what had been hers from the beginning and a recovery of the new value which accrued during detention. On this basis part of the expense was treated as a capital expenditure for vindicating title to property, not deductible under Section 212, and part as a deductible ordinary expense of recovering income which had been wrongfully withheld from its owner. To us this distinction seems unrealistic. The wife was trying to recapture her property and accepted current value in cash in lieu of the property itself. We are unable to see how the form of the recovery prevented any part of the attendant expense from being a nondeductible expense of vindicating title. We think it would be a mistake to follow the guidance of the *Coke* case."

Thus, the Court of Appeals refused to follow a case which not only was officially acquiesced in by the Commissioner of Internal Revenue, but which was impliedly approved by Congress in enacting the 1954 Internal Revenue Code. In *Commissioner v. United States*, 358 U. S. 498 (1959), this Court held that where unambiguous regulations under the Code have been in effect for many years and construed by the Courts, Congress in reenacting the provisions in the 1954 Code must be considered to have accepted the interpretation placed on the previous provision. This rule is particularly appropriate as applied to Section 212, because Congress specifically examined the prior interpretations of the predecessor section to Section 212 and added a new category of deductions for tax litigation expenses which had been disallowed under interpretations of the earlier provision.

(b) *Naylor v. Commissioner*, 201 F. 2d 746, (5th Cir. 1953).

In the *Naylor* case the taxpayer owned shares of stock on which he had given an option. The option was exercised and thereafter a dispute arose as to the proper price to be paid under the terms of the option. The taxpayer employed an attorney to obtain the price which he claimed. After negotiations a compromise settlement was entered into under which the taxpayer received a sum $140,000 in excess of the price which he had been offered. The Court of Appeals, reversing the Tax Court, held that the taxpayer was entitled to deduct counsel fees in the amount of $28,000 under Section 23(a)(2) as an ordinary deduction, rather than as an offset to the capital gain.

The Court of Appeals in the present case agreed that in the *Naylor* case the expense was deductible as an expense for the collection of capital gains income. However, it held that in the present case the expense incurred in 1954 was an expense of a sale in 1936. Since in the *Naylor* case the expense was incurred before the delivery of the stock and

before receipt of any of the purchase price, while in the present case the expense was incurred eighteen years after delivery of the stock and payment of the original purchase price, it is clear that the decision in this case actually is inconsistent with the *Nunber* case.

(c) *Ruoff v. Commissioner*, 277 F. 2d 222, (C. A. 3, 1960).

In the *Ruoff* case, decided by the Third Circuit on April 6, 1960, after the argument in the present case, the taxpayer paid legal fees in a suit in which by settlement she recovered from the Alien Property Custodian (1) money, representing the sale to the Custodian as part of the settlement of a life interest in a trust which had been seized by the Custodian, and (2) various securities which had been seized by the Custodian. The Commissioner contended, and the Tax Court ruled, that the legal fees paid were not deductible under Section 23(a)(2) and that part of the fee was required to be allocated to the basis of the life interest in computing the long-term capital gain on the sale of such life interest, and the balance was required to be added to the basis of the securities recovered. The Court of Appeals for the Third Circuit reversed the Tax Court and held that the fees were deductible in their entirety under Section 23(a)(2) of the 1939 Code, the predecessor to Section 212 of the 1954 Code.

Thus, in the *Ruoff* case, the taxpayer recovered money representing the proceeds of the sale of her life estate (a capital asset), resulting in a long-term capital gain, and the Court of Appeals held that the expenses of such recovery were deductible from ordinary income and were not capital expenditures to be used in the reduction of the capital gain on such sale. Yet in the present case, the same Court of Appeals without citation of the *Ruoff* case, denied deduction for the expenses of recovering additional gain in 1954 on a sale which took place in 1936.

(d) *Heller v. Commissioner*, 2 T. C. 371, *aff'd*. 147 F. 2d 376 (9th Cir.), *cert. den.* 325 U. S. 868.

In the *Heller* case the taxpayer refused to exchange his shares of stock in Associated Oil Company for shares of Tidewater Oil Company pursuant to a merger plan. After litigation, the taxpayer received $50 per share in cash for his stock, realizing a capital gain. The Court held that the legal expenses of such litigation were deductible.

The taxpayer in *Heller* obviously was not in as good a position as the Petitioner here to claim the deduction. There, the legal expenses were incurred in the very litigation which resulted in the sale of the stock and the consequent realization of gain, while, here, petitioner's expenses were incurred in a suit resulting in the recovery of capital gains income with respect to a sale consummated eighteen years earlier. Despite this and the failure of Defendant to even attempt to distinguish the *Heller* case, the Court of Appeals ignored it in its Opinion.

2. Conflict in Principle With Decisions of This Court.

The Court of Appeals gave what appears to be its underlying reason for concluding as it did as follows (13a):

> "As an additional consideration, we are the more disposed to approve the capitalization of the item in suit because a contrary conclusion would enable a taxpayer to benefit inequitably from the circumstances that ordinary income and capital gains are taxed at different rates. Suppose the amount in excess of cost realized from the sale of a capital item is exactly equal to the expenditures necessary to accomplish the sale and allocable solely to it. If such expense is capitalized the taxpayer's return will show no capital gain and, for tax purposes, the entire transaction has no effect. This seems fair. But if the taxpayer reports his profit apart from this expense as a capital gain and then deducts the expense from gross income, in which only a part of

> the capital gain is included, he actually reduces his income tax through a transaction which, in a business sense, has resulted in neither gain nor loss. We think this should not be permitted unless it is plainly required by the tax laws. We have already pointed out that in our view the tax laws may reasonably be construed in a way which avoids such a consequence."

This assumption that Congress did not intend that deductions be allowed from ordinary income for expenses which did not result in the realization of ordinary income is not only contrary to the Regulations[3] and the Committee Reports,[4] but conflicts with decisions of this Court.

In *Bingham v. Commissioner*, 325 U. S. 365 (1945), this Court made it clear that the deduction under Sec. 23(a)(2) [Sec. 212] is not dependent upon the production of *any* income at all. There, the trustees of a trust claimed a deduction against ordinary income under Sec. 23(a)(2) for legal expenses incurred (1) in contesting an income tax deficiency asserted against capital gain income of the trust, and (2) for legal advice concerning final distribution of the assets of the trust. The Commissioner contended, inter alia, in accordance with his Regulations, that the deduction was not allowable under Sec. 23(a)(2) because the expenses did not result in the production of income. This Court allowed the deduction and struck down the Regulation in so far as it "purports to deny deduction of litigation expense unless it is to produce income." The Court pointed out that although the production of income is one basis for allowing the deduction, the other bases do not require that income be produced.

Since, as held by this Court in *Bingham*, Section 212 allows deductions even where no income of any kind is produced, it is clearly inconsistent to insist, as the Court below did, that where income is produced the deduction is not

3. See Regulations quoted *supra*, p. 3.

4. See H. Rep. 2333, 77th Cong., 1st Sess., 1942-2 C. B. 429-30.

allowable under Section 212 if that income happens to be capital gains income.

The reasoning of the Court below is similar to that rejected by this Court in *Helvering v. Bliss*, 293 U. S. 144 (1934). There, the statute allowed as an ordinary deduction charitable contributions limited to 15% of the taxpayer's net income. The taxpayer realized capital gains subject to the lower capital gains tax rate. The Commissioner thought it inequitable to permit the taxpayer to use the capital gains as part of the net income in measuring the limitation on the contributions deduction, because the capital gains operated to increase the limitation on a deduction from ordinary income even though the capital gains were segregated and taxed at special lower rates. However, the answer of this Court is equally appropriate here (p. 150):

> "By the express words of § 23(n) charitable contributions are to be deducted to ascertain net income as defined in § 21; and nothing in § 101, which prescribes merely a method for segregating a portion of the net income for taxation at a special rate, in any wise alters the right of the taxpayer to take the deduction in accordance with § 23(n)."

Similarly, by the express words of Section 212 and the Regulations, the expenses for recovering or "collection" of capital gain income are deductible in ascertaining taxable income; and nothing in Section 1201, which prescribes merely a method for segregating a portion of that taxable income for taxation at a special rate, in any wise alters the right of the taxpayer to take such deduction.

CONCLUSION.

For the foregoing reasons, this Petition for Writ of Certiorari should be granted.

Respectfully submitted,

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Appendix.

OPINION SUR MOTION TO DISMISS.

Before KIRKPATRICK, *J.*

This is an action to recover a duly claimed refund of income tax in the amount of $44,362.95 alleged to have been erroneously collected as part of the plaintiff's * 1954 income tax. The defendant has moved to dismiss on the ground that the facts stated in the complaint and in the claim for refund thereto attached (and admitted for the purposes of this motion) fail to state a claim upon which relief can be granted.

The question presented is whether legal expenses incurred by the taxpayer in a suit resulting in the rescission of the sale of corporate stock and the transfer of corporate assets are deductible from ordinary income by reason of having been incurred for the production of income within the meaning of Section 212 of the Internal Revenue Code of 1954.

Briefly stated, the essential facts are that Bethlehem Steel Company by purchase in 1936 acquired the stock of the plaintiff and other stockholders in the Williamsport Wire Rope Company and, by means of receivership proceedings, acquired all the assets of the same company.

In 1952, upon a petition filed by the plaintiff and other stockholders, the District Court found that the sales of stock and the transfer of assets had been induced by fraud and entered a decree declaring the receiver's sale null and void and declaring Bethlehem constructive trustee of the stock and assets. Shortly thereafter, while motions for a

* There are two plaintiffs, husband and wife, but in this opinion I have referred to them collectively as "the plaintiff".

new trial were pending, the parties agreed to a compromise settlement in pursuance of which Bethlehem paid $6,000,000., the Court vacated its decree, and the stockholders released Bethlehem from all claims arising out of their ownership of the stock. The plaintiff received some $220,000 out of which he paid counsel fees of $110,641.10. In his income tax return for 1954 he included the amount received as long term capital gain and deducted the expenditures by him of counsel fees as "ordinary and necessary expenses paid or incurred during the taxable year for the production or collection of income". (Internal Revenue Code of 1954, Section 212(1)).

The counsel fees were disallowed as an ordinary expense deduction but were treated as a reduction of the reported capital gain.

The Treasury Regulations (Section 1.212-1) provide that "Expenses paid or incurred in defending or perfecting title to property, in recovering property (other than investment property and amounts of income which, if and when recovered, must be included in gross income) . . . constitute a part of the cost of the property and are not deductible expenses . . ." Thus, by the regulation, expenses paid in recovering property are excluded from the statutory definition of expenses paid for the production or collection of income. This distinction has been adopted in a number of decisions. See *Helvering v. Stormfeltz*, 142 F. 2d 982; *Garrett v. Crenshaw*, 196 F. 2d 185; *Megargel v. Commissioner*, 3 T. C. 238.

Were these fees incurred for the "recovery of property"? The taxpayer does not base his case upon the fact that in the end he did not get property but only money, evidently (and correctly) feeling that the form in which his recovery finally came to him was not conclusive upon the question of what the fees were expended for. In effect, what he contends is that his action to rescind the fraudulent sales was a mere matter of form and that what he was really trying to accomplish was to get an increase of the price over

what Bethlehem had already paid him. In support of this theory he suggests that, inasmuch as Williamsport had been liquidated by Bethlehem into its business as a result of the sale, recovery of the title to the stock would have meant nothing. However, the provisions of the Court's decree nullifying the sale of the assets and rescinding the sales of stock were all in the same proceeding. Williamsport had not been dissolved and the defrauded stockholders, by virtue of the decree declaring Bethlehem constructive trustee, were in a position to enforce the company's rights against Bethlehem in respect of the assets. Whether the suit technically was to recover the stock or the assets is immaterial. Either way, it was for the recovery of property.

I do not think that it is possible to hold that the taxpayer's suit against Bethlehem was merely a legal fiction used to compel Bethlehem to pay more money for stock which it had already purchased. In fact, it appears from the decree of the Court approving the settlement that there were stockholders who had not sold their stock to Bethlehem who participated in the proceeds of the lawsuit. The plaintiff filed a petition and prosecuted a lawsuit the basis of which necessarily was that he and not Bethlehem owned the stock. He might have sued for damages, but he elected to sue for the property. I do not believe that I am permitted to take into account an undisclosed intention on his part, in order to give a character to his suit contrary to his petition.

The fact is that the plaintiff did, to all practical intents and purposes, recover his property. By the decree of the Court, he became the equitable owner of it, Bethlehem holding it merely as constructive trustee. The effect of the settlement was to transfer his equitable title to the stock to Bethlehem exactly as though he had executed an instrument of sale with the usual phraseology. I agree with the defendant that the substance of what happened was the restoration of title to the taxpayer followed by a sale of the stock to Bethlehem. This was clearly, in fact as well

as in form, a suit to recover property, ultimately settled, and nothing more. As such, the expenses of litigation must be deducted from the capital gain and cannot be treated as ordinary and necessary expenses paid for the production or collection of income.

The Court of Appeals for the Third Circuit in Condenser Service and Engineering Co. v. Commissioner, 200 F. 2d 959—a case which would have been on all fours with the present case if Bethlehem had succeeded in establishing its title to the stock and was claiming *its* legal expenses as a deduction from ordinary income—decided that the expenses were not so deductible because incurred in defending its property. There is no logical reason to treat the successful plaintiff in a fraud action to rescind a sale differently from a successful defendant who has been able to maintain his ownership of the property in the same sort of action brought for the same purpose.

The cases cited by the plaintiff are distinguishable. In Naylor v. Commissioner, 203 F. 2d 346, the plaintiff was affirming his contract of sale which had been consummated by delivery of the stock and seeking to enforce it. The dispute was about the price. The case of Coke v. Commissioner, 17 T. C. 403, affirmed 201 F. 2d 742, involved not only a claim for stock but claims for other monies that might be due, and, if the decision be treated as allowing an apportionment of so much of the counsel fee as can be attributed to other monies recovered, I can agree with it. However, the point is not entirely clear and, if it means more than this, I can only say that it does not seem to be in accord with the great weight of decisional law. In Heller v. Commissioner, 147 F. 2d 376, the taxpayer was merely trying to get more money for his stock which was to be cancelled upon a merger. In United States v. Pate, 254 F. 2d 480, no question of title was involved. The expenses were incurred in a suit for damages caused by negligence.

The motion to dismiss is granted.

JUDGMENT.

Before KIRKPATRICK *J.*

AND NOW, to wit: October 1, 1959, in accordance with the Opinion of the Court granting defendant's motion to dismiss, it is ORDERED that the above action be and the same is hereby dismissed with costs to the defendant.

By THE COURT:

Attest:

/s/ ROBERT E. CRISWELL,
Deputy Clerk.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 13,086

GEORGE S. MUNSON AND KATHARINE S. MUNSON,
Appellants

v.

EDGAR A. McGINNES, INDIVIDUALLY AND AS UNITED STATES DISTRICT DIRECTOR OF INTERNAL REVENUE FOR THE INTERNAL REVENUE DISTRICT OF PHILADELPHIA, PENNSYLVANIA.

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF PENNSYLVANIA

Argued February 18, 1960

Before: BIGGS, *Chief Judge;* and STALEY and HASTIE, *Circuit Judges.*

OPINION OF THE COURT

(Filed June 8, 1960)

By HASTIE, *Circuit Judge.*

This is an appeal from an order of a district court granting a motion of the defendant Director of Internal Revenue to dismiss the plaintiff taxpayer's[1] suit for a

1. Although this litigation involves a joint return of George S. Munson and his wife Katharine S., the husband will be referred to as the taxpayer.

refund of income taxes as failing to state a valid claim for relief. In dispute is the manner in which the taxpayer is entitled to deduct a $110,000. attorney's fee in the computation of his income tax. The circumstances under which this fee was paid, set forth in the taxpayer's claim for refund and recognized by the government as correct, are these.

The fee was paid for professional services in winning a litigated controversy about a sale of the stock and assets of the Williamsport Wire Rope Co. to Bethlehem Steel Co. In 1936 Bethlehem owned bonds of Williamsport which were in default. Plaintiff owned a substantial amount of Williamsport stock. Bethlehem caused Williamsport to be placed in receivership and the mortgage to be foreclosed. With Williamsport thus embarrassed the taxpayer and the other Williamsport stockholders accepted an offer of Bethlehem to buy their stock. The receiver then sold the Williamsport assets to Bethlehem, which thereafter completely liquidated Williamsport.

A few years later former Williamsport stockholders, among them the plaintiff, sued in the court where the Williamsport receivership had been administered asking that the matter be reopened, the scheme by which Bethlehem acquired the Williamsport assets to be declared fraudulent and that these assets be traced, identified and returned to the former Williamsport stockholders.

The court found that the sales of Williamsport stock to Bethlehem and the acquisition of Williamsport assets by Bethlehem had resulted from fraud and that Bethlehem should be declared constructive trustee of such stock and assets for the defrauded Williamsport stockholders. *Guaranty Trust Co. v. Williamsport Wire Rope Co.*, M. D. Pa. 1952, 107 F. Supp. 759. Pending disposition of a motion for new trial, Bethlehem proposed and plaintiffs in that action agreed to a settlement of the entire controversy. The court considered this proposal, found it equitable, vacated judgment, filed a second opinion and entered judgment accordingly. 107 F. Supp. 762. In this final disposition the court

stated that the administration of the Williamsport receivership had been so fraudulent as to warrant the setting aside of the sale of the Williamsport properties but that Bethlehem, which had benefited from the fraud, had not been party to it. The remedy decreed was the payment of an additional $6,000,000, by Bethlehem to the former Williamsport stockholders. To accomplish this Bethlehem was ordered to deposit both $6,000,000, and the certificates of Williamsport stock it had acquired from the former stockholders with the court so that the former stockholders might be identified and the $6,000,000, properly allocated among and distributed to them. This was done and the share of the fund allocated and paid to taxpayer was approximately $220,000., out of which he paid the $110,000., counsel fee which is the subject of the present controversy.

It will be observed that the theory of claim in the above-described proceeding was that fraudulent misconduct had caused stockholders to part with their Williamsport stock. And the agreed and decreed remedy was the payment of additional money to these seller[s] the purchaser of the stock. Accordingly, in his 1954 income tax return taxpayer treated the proceeds of the litigation as additional consideration for his Williamsport stock, from which he realized long term capital gain. He did this by subtracting from the $220,000. awarded him the portion of his stock basis not used up by the payment originally received from Bethlehem and treating the difference as capital gain. However, in this computation he did not subtract from the $220,000. awarded him, the $110,000. which he was required to pay counsel for successfully asserting and litigating this claim. Instead, he treated this fee as "an ordinary and necessary [expense] paid or incurred during the taxable year . . . for the production or collection of income", fully deductible from gross income under Section 212(1) of the 1954 Internal Revenue Code.

The Commissioner disallowed the deduction as claimed and treated the fee as an item to be taken into account as an

offset reducing the capital gain realized on the sale of stock. He assessed a deficiency accordingly. The taxpayer paid the deficiency assessment and brought this suit for the recovery of the amount thus paid. The district court denied the claim and the taxpayer has appealed.

A nonbusiness expense related to the sale of property may arguably be viewed in either of two ways. First, it may be treated as a capital expenditure to be taken into account as reducing the capital gain realized through the sale. See Sections 1001(a), 1011, 1016(a)(1), Int. Rev. Code of 1954. In such circumstances, for income tax purposes the expense is added to the taxpayer's basis for the property and this aggregate subtracted from the selling price to determine the amount of taxable capital gain. From the taxpayer's point of view this is the less favorable procedure since it merely reduces the capital gain, which is less severely taxed than ordinary income.

On the other hand a nonbusiness expense related to selling may qualify for a more advantageous deduction from gross income as an "ordinary and necessary [expense] . . . for the production or collection of income" under Section 212 of the 1954 Code. This possibility is suggested and emphasized by the explicit provision of the Regulations promulgated under Section 212 that "the term income for the purpose of Section 212 . . . is not confined to recurring income but applies as well to gains from the disposition of property". C. F. R. 1960, 1.212-1(b). However, the same section of the Regulations makes it clear that all expenses connected with the gainful disposition of property are not thus deductible. Indeed, it is explicitly stated that deductions for "capital expenditures are not allowable . . . ." (1.212-1(n). The sense of this seems to be that a capital expenditure is not to be treated as an "ordinary . . . expense" within the meaning of Section 212.

It will be noted that this problem is not likely to arise where expenditures are deducted under Section 212 as costs

of "collection" of income, since conceptually expenses of "collecting" income are not expenses of a capital transaction. If chronology were decisive the present case might be characterized as presenting such a cost of collection, since the dispute arose after a sale was agreed upon and consummated. More analytically, if terms of sale have been agreed and subsequent controversy concerns no more than enforcement of these terms against a defaulter the problem is one of "collection". *Naylor v. Commissioner*, 5th Cir. 1953, 203 F. 2d 346. If the problem is to reach mutually satisfactory or binding terms of sale, the problem is one of disposing of the property, not of collection, and the question of capitalization must be faced.

Here there was no dispute as to what the original terms of sale were and no difficulty in obtaining the buyer's compliance with them. Rather, there was a successful effort to establish that the original terms of sale were so unjust as a result of underlying fraud that equity should require their modification to provide the seller a larger consideration. We need not say, as the government urges, that the seller reacquired and resold the stock to conclude that what occurred was in substance and reality an equitable revision of the original terms of sale. Thus, the counsel fee in question was, to one in the seller's position, an expense of modifying terms of sale, incurred as an essential incident of a capital transaction in the disposition of property. Our problem is to decide whether it is the kind of selling expense which must be capitalized, and the "collection" cases do not help us.

In rationalizing such capitalization and the restriction it imposes on the deduction of expenses under Section 212. (1), courts have relied greatly upon the treatment which has long been accorded equivalent language in the much older provision, now Section 162 of the 1954 Internal Revenue Code, authorizing the deduction of ordinary and necessary business expenses. It is now authoritatively established

that the two sections are *in pari materia*. *Bingham v. Commissioner*, 1945, 325 U. S. 365; *McDonald v. Commissioner*, 1944, 323 U. S. 57. Accordingly, it has been reasoned that in those situations where the capitalization of business selling expenses is a long established and accepted requirement, despite Section 162, equivalent or closely analogous nonbusiness expense must also be capitalized and used only as an offset to capital gain, despite Section 212(1). On this basis selling commissions, required to be capitalized in the regulations concerning the deduction of business expenses, C. F. R., 1960, § 1.263(a)-2(e), but not mentioned at all in the regulations under Section 212, are equally deductible in both situations. *Davis v. Commissioner*, 8th Cir., 1945, 151 F. 2d 441, applying to a commission paid for a nonbusiness sale, the rule of *Spreckels v. Commissioner*, 1942, 315 U. S. 626, a business expense case. This concept also embraces fees paid to lawyers for negotiating sales. *Dwight A. Ward*, 1953, 20 T. C. 332. Similar treatment has been accorded expenses of a seller for revenue stamps and title abstracts. *Mrs. E. A. Griffin*, 1930 B. T. A. 1043. And, in a case involving nonbusiness expenses, a seller has been required to capitalize not only selling commissions but also the cost of an underwriter's commission and S. E. C. registration in connection with a sale of securities. *Davis v. Commissioner*, *supra*.

Two circumstances seem to characterize this group of selling expenses. First, they are incurred either to achieve an enforceable bargain or to complete essential formalities of sale. They are peculiarly selling expenses rather than collection expenses, as these categories were distinguished early in this opinion. Second, each is in itself a distinct item of cost incurred and necessary solely to facilitate a particular capital transaction. There is no problem of allocation such as is created by expenditures like overhead costs which have general significance for gainful transactions but require artificial pro rata allocation to bring them into proximate relation with any particular selling. Each ex-

pense which must be capitalized presents the simple economic reality of a particular cost of a particular capital transaction.

The present legal fee exhibits the same characteristics. Therefore, we think it belongs in the same category of capital expenditures.

It deserves mention that this conclusion is in harmony with, though not controlled by, the numerous cases which require capitalization of expenses incurred in vindicating title to property. *E.g., Garrett v. Crenshaw*, 4th Cir. 1952, 196 F. 2d 185; *Helvering v. Stormfeltz*, 8th Cir., 1944, 142 F. 2d 982. Such cases are not controlling here because they relate to costs of an effort to retain or retake property rather than to sell it or establish acceptable terms of disposition.[2] Yet, it seems anomalous to require capitalization of expenses of the party who is on one side of a negotiation or controversy over the disposition of a capital asset while permitting the opposing party to claim an ordinary deduction of his equivalent expenses. Thus, the court below was impressed by the anomaly of a rule which would compel Bethlehem to capitalize its costs of defending the present proceeding, as cases like *Condenser Service & Engineering Co. v. Commissioner*, 3d Cir. 1953, 200 F.2d 959 and *Murphy Oil Co. v. Burnet*, 9th Cir., 1932, 55 F. 2d 17, require, yet would permit the taxpayer to claim a general deduction for his costs in prosecuting the same litigation. True, the one party comes directly under the Regulation defining the defense of title exception to the allowance of a deduction for ordinary expenses, § 1.212-1(k), while the other does not. Yet, it seems fair and sensible to accord like tax treatment to the litigation expenses of both parties to a dispute over a particular disposition of property, where legal basis can be found for doing so.

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2. We have not discussed the Regulation covering such expenses because it too is inapplicable to the disposition of property as distinguished from its retention or recapture. C. F. R., 1960, § 1.212-1 (k).

As an additional consideration, we are the more disposed to approve the capitalization of the item in suit because a contrary conclusion would enable a taxpayer to benefit inequitably from the circumstance that ordinary income and capital gains are taxed at different rates. Suppose the amount in excess of cost realized from the sale of a capital item is exactly equal to the expenditures necessary to accomplish the sale and allocable solely to it. If such expense is capitalized the taxpayer's return will show no capital gain and, for tax purposes, the entire transaction has no effect. This seems fair. But if the taxpayer reports his profit apart from this expense as a capital gain and then deducts the expense from gross income, in which only a part of the capital gain is included, he actually reduces his income tax through a transaction which, in a business sense, has resulted in neither gain nor loss. We think this should not be permitted unless it is plainly required by the tax laws. We have already pointed out that in our view the tax laws may reasonably be construed in a way which avoids such a consequence.

Finally, we have not overlooked taxpayer's urging that *Coke v. Commissioner*, 1951, 17 T. C. 403, *aff'd per curiam*, 5th Cir. 1953, 201 F. 2d 742, supports his claimed deduction. That was a case in which property belonging to a wife had been wrongfully withheld from her in a settlement made on divorce. Question arose as to the tax treatment of expenses she incurred in recovering from her divorced husband an amount which was viewed as both a recapture of what had been hers from the beginning and a recovery of the new value which accrued during detention. On this basis part of the expense was treated as a capital expenditure for vindicating title to property, not deductible under Section 212, and part as a deductible ordinary expense of recovering income which had been wrongfully withheld from its owner. To us this distinction seems unrealistic. The wife was trying to recapture her property and accepted current value

in cash in lieu of the property itself. We are unable to see how the form of the recovery prevented any part of the attendant expense from being a nondeductible expense of vindicating title. We think it would be a mistake to follow the guidance of the *Coke* case.

For these reasons the decision of the district court will be affirmed.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT.

No. 13,086.

GEORGE S. MUNSON AND KATHARINE S. MUNSON,
Appellants,

v.

EDGAR A. McGINNES, INDIVIDUALLY AND AS UNITED STATES DISTRICT DIRECTOR OF INTERNAL REVENUE FOR THE INTERNAL REVENUE DISTRICT OF PHILADELPHIA, PENNSYLVANIA.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE EASTERN DISTRICT OF PENNSYLVANIA.

Present: BIGGS, *Chief Judge*, and STALEY and HASTIE, *Circuit Judges*.

JUDGMENT

This cause came on to be heard on the record from the United States District Court for the Eastern District of Pennsylvania and was argued by counsel.

On consideration whereof, it is now here ordered and adjudged by this Court that the judgment of the said District Court in this case be, and the same is hereby affirmed.

Attest:

IDA O. CRISKOFF,
Clerk.

June 8, 1960.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT.

No. 13,086.

GEORGE S. MUNSON AND KATHARINE S. MUNSON,
Appellants,

v.

EDGAR A. McGINNES, INDIVIDUALLY AND AS UNITED STATES DISTRICT DIRECTOR OF INTERNAL REVENUE FOR THE INTERNAL REVENUE DISTRICT OF PHILADELPHIA, PENNSYLVANIA.

OPINION SUR PETITION FOR REHEARING.

Present: BIGGS, *Chief Judge*, and STALEY and HASTIE, *Circuit Judges*.

After due consideration the petition for rehearing in the above-entitled case is hereby denied.

By THE COURT,

WILLIAM H. HASTIE
William H. Hastie,
Circuit Judge.

Dated: July 25, 1960.